93-813

No. _____

Supreme Court, U.S.
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IN THE

Supreme Court of the United States

October Term, 1993

ALCAN ALUMINUM CORPORATION,
Petitioner,

vs.

FRANCHISE TAX BOARD OF THE STATE OF CALIFORNIA,
Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE COURT OF APPEAL OF THE STATE OF CALIFORNIA IN AND FOR THE THIRD APPELLATE DISTRICT

PETITION FOR WRIT OF CERTIORARI

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QUESTION PRESENTED

Whether the use of a three-factor formula generally referred to as worldwide combined reporting, which assigns a portion of the worldwide income of a group of companies headed by a non-United States domiciled foreign parent by comparing sales, payroll and property values in California with sales, payroll and property values around the world, violates the foreign Commerce Clause of the United States Constitution, Article I, Section 8, Clause 3.

RULE 29.1 STATEMENT

Petitioner, Alcan Aluminum Corporation, is a wholly-owned subsidiary of Alcan Aluminium Limited, a corporation organized and existing under the laws of Canada.

Alcan Aluminum Corporation's subsidiaries include Alcan-Toyo America, Inc., Alcan Sumitomo Electric, Inc., Logan Aluminum, Inc., the Aluminum Railcar Company, Polyfiltronics N.A., Inc., Ampersand Corporate Spin-off Ventures and Lanxide Corporation.

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PETITION FOR WRIT OF CERTIORARI

OPINIONS BELOW

The Superior Court of the State of California for the County of Sacramento issued its Decision on May 31, 1991 entering judgment for Respondent Franchise Tax Board. That decision is reprinted in the Appendix at A21.

The Court of Appeal of the State of California, Third Appellate District, affirmed the lower court in an unreported decision issued on June 17, 1993, which is reprinted in the Appendix at A1.

The California Supreme Court denied Petitioner's Petition for Review by Order dated September 22, 1993, which is reprinted in the Appendix at A20.

JURISDICTION

The Court of Appeal of the State of California, Third Appellate District, affirmed the decision of the Superior Court for the County of Sacremento on June 17, 1993.

Petitioner timely filed a Petition for Review in the Supreme Court of California on July 23, 1993. That Petition for Review was denied on September 22, 1993, thereby rendering final the decision of the Court of Appeal. Petitioner presently seeks review of those orders.

The jurisdiction of the Supreme Court of the United States is invoked pursuant to 28 U.S.C. §1257(a).

CONSTITUTIONAL PROVISIONS AND STATUTES INVOLVED

United States Constitution, Article I, Section 8, Clause 3 (the Commerce Clause) provides that:

> [The Congress shall have Power] To regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes.

California Revenue and Taxation Code §25101 states:

> §25101. Basis of allocation
>
> When the income of a taxpayer subject to the tax imposed under this part is derived from or attributable to sources both within and without the state the tax shall be measured by the net income derived from or attributable to sources within this state in accordance with the provisions of Article 2 (commencing with Section 25120). However, any method of apportionment shall take into account as income derived from or attributable to sources without the state, income derived from or attributable to transportation by sea or air without the state, whether or not the transportation is located in or subject to the jurisdiction of any other state, the United States or any foreign country.
>
> If the Franchise Tax Board reapportions net income upon its examination of any return, it shall, upon the written request of the taxpayer, disclose to it the basis upon which its reapportionment has been made.

California Revenue and Taxation Code §25137 states:

> §25137. Proceedings where allocation and apportionment provision fail to fairly represent taxpayer's business activity in state
>
> If the allocation and apportionment provisions of this act do not fairly represent the extent of the taxpayer's business activity in this state, the

taxpayer may petition for or the Franchise Tax Board may require, in respect to all or any part of the taxpayer's business activity, if reasonable:

(a) Separate accounting;

(b) The exclusion of any one or more of the factors;

(c) The inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this state; or

(d) The employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

STATEMENT OF THE CASE

This is an action seeking the refund of franchise taxes paid to the State of California during the years 1972 through 1974. The franchise tax was computed by the unitary or formulary method of taxation, also referred to as worldwide combined reporting ("WWCR"), applied to a non-domiciled foreign parent combination. It is Petitioner Alcan Aluminum Corporation's ("Alcan") contention that such a tax violates the foreign Commerce Clause of the United States Constitution, Article I, Section 8, Clause 3. Alcan is a wholly owned subsidiary of Alcan Aluminium Limited ("Limited"), which is a corporation organized and existing under the laws of Canada. Limited's headquarters and principal place of business are in Montreal, Quebec, Canada. Limited and various of its subsidiaries are engaged in all phases of the aluminum business on an international scale. Neither Limited nor its non-United States subsidiaries have a permanent establishment in the United States.

Alcan, the Petitioner in this case, was at the time in question a corporation organized and existing under the laws of the State of New York with its principal place of business in Cleveland, Ohio. Alcan and its subsidiaries are engaged in the business of fabricating and selling various aluminum products in the United States. Certain activities of Alcan are conducted in the State of California.

The Respondent in this case is the Franchise Tax Board of the State of California ("FTB"). Since 1972, the FTB has assessed franchise taxes on Alcan for doing business in the State of California on what is known as a "unitary" basis. Under this method of taxation, the income of the unitary business attributable to California is calculated by a three-factor formula which multiplies

the total worldwide income of Limited by the relative percentage of that business' property, payroll and sales in California.

The result of WWCR is that FTB has measured and assessed franchise taxes not solely on the income of Alcan and its United States affiliates, but also on the worldwide income of Limited and all of Limited's non-United States subsidiaries (the "Alcan Unitary Business"). The purpose and effect of the Respondent's actions are to greatly inflate the amount of tax assessed and collected by attributing to California a portion of the worldwide income of Limited and its non-United States subsidiaries all of whom have no permanent place of business in the United States and all of their income is subject to the tax rules of the host country in which they conducted business and in Canada upon distribution.

The effect of this taxation is to tax the income of Limited and its non-United States subsidiaries multiple times and effectively to tax Limited's non-United States foreign operations. In addition, it has the potential to impose substantial costs of compliance upon Limited and its non-United States subsidiaries. The existence of multiple taxation and the absence of a sufficient nexus upon which to predicate a tax on activities that take place exclusively in foreign commerce, as well as the discriminatory impact of the compliance burden, constitute a violation of the foreign Commerce Clause. Finally, because of the foregoing and because of the international understanding that the taxation of foreign subsidiaries must be done exclusively on an arm's length/separate accounting ("AL/SA") basis, the Respondent's method of taxation interferes with the foreign policy of the United States and its ability to "speak with one voice," again violating the foreign Commerce Clause of the United States Constitution.

In 1984, Limited commenced an action in the Federal District Court for the Northern District of Illinois. The purpose of that action was to seek an injunction and declaratory judgment that the present tax violated the foreign Commerce Clause of the United States Constitution. This case was held in abeyance by agreement between the parties pending the resolution of the federal action. In 1990, this Court rendered an Opinion that held that the federal action was tentatively barred by the Tax Injunction Act on the presumption that Alcan could raise and have adjudicated in its refund action in the California courts all of the injuries to Limited. *Franchise Tax Board v. Alcan Aluminium, Ltd.*, 493 U.S. 331 (1990). As a result of that ruling by this Court, the present case proceeded.

Alcan raises essentially the same constitutional issues in this case that Limited had raised in the federal action. The parties filed cross motions for summary judgment based on stipulations of fact. The Sacramento County Superior Court entered judgment for FTB and Alcan appealed. The Third Appellate District of the Court of Appeal of the State of California affirmed the trial court on June 17, 1993. Alcan duly filed its Petition for Review with the California Supreme Court on July 23, 1993. That Petition for Review was denied on September 22, 1993. Alcan now seeks to have this Honorable Court grant its Petition for a Writ of Certiorari so that this Court may address the essential constitutional issues raised by this appeal.

THE PROCEEDINGS BELOW

A. The Federal Question Raised In This Case

In Petitioner's pleadings and briefs in the California Superior Court for the County of Sacramento, in its Briefs in the California Court of Appeal, Third Appellate District, and in its Petition for Review to the California Supreme Court, Alcan contended that the Respondent's use of WWCR as applied to a non-domiciled foreign parent combination violated the Commerce Clause of the United States Constitution.

B. The Decisions Below

1. *The California Superior Court for the County of Sacramento*

The Sacramento Superior Court entered judgment in favor of Respondent relying exclusively on this Court's reasoning in *Wardair Canada v. Florida Department of Revenue*, 447 U.S. 1, 7-8 (1986), in which "the Court clarified that the Dormant Commerce Clause analysis set forth in *Japan Line* [*Ltd. v. County of Los Angeles*, 441 U.S. 434 (1979)] for determining whether a tax violates the Foreign Commerce Clause does not apply when the Federal Government has affirmatively acted in a manner which permits the state tax." A23.

The Sacramento Superior Court stated that the Federal Government's affirmative action to permit states to use WWCR was established by "negative implication." A23. In support of its reasoning, the Court cites an example of an income tax treaty that the United States negotiated with the United Kingdom in 1975. The treaty included a provision prohibiting states from using WWCR. However, the treaty was not ratified by the Senate until after this provision was omitted. The

Court indicates that numerous bills prohibiting states from using WWCR have been introduced in Congress since ratification of the United Kingdom treaty but none have been enacted. The Sacramento Superior Court concluded that "[t]he evidence in this case indicates that the Federal Government has affirmatively acted to allow the states to use WWCR at least until Congress passes legislation to the contrary." A24. Therefore, the Court concluded that no Dormant Commerce Clause analysis was necessary.

The Court also granted the Respondent's Motion *in Limine* to exclude evidence of the costs of compliance because the Court found that Alcan failed to exhaust its administrative remedies by failing to present any factual evidence during the administrative process of what the costs of compliance were or would be. A22.

2. *The California Court of Appeal, Third Appellate District*

The Court of Appeal affirmed the decision of the Sacramento Superior Court relying on the California Supreme Court's decision in *Barclays Bank International Ltd. v. Franchise Tax Board*, 829 P.2d 279, 280, 294, 300 (1992), *cert. denied, Barclays Bank PLC v. Franchise Tax Board*, ____ U.S. _____, 113 S. Ct. 202 (1992), *cert. granted*, (U.S. Nov. 1, 1993) (No. 92-1384)[1] which held

[1] The California Supreme Court remanded the *Barclays* case to the Court of Appeal on the issue of the discriminatory effect of the compliance burdens on the Commerce Clause and the due process issue. While the remand was pending, Barclays sought review by this Court. That Petition was denied on October 5, 1992. The Court of Appeal rendered its decision on remand on November 20, 1992 and denied a Petition for Rehearing on December 18, 1992. The California Supreme Court denied a Petition for Review on February 18, 1993. Barclays then filed a Petition for Writ of Certiorari to this Court which was granted on November 1, 1993.

that an "unexercised" foreign Commerce Clause analysis is not applicable because such analysis is used only where Congress has failed to exercise its commerce power. Quoting *Barclays*, the Court stated:

> It would turn dormant Commerce Clause analysis entirely upside down ... to apply it where the Federal Government has acted, and to apply it in such a way as to *reverse* the policy that the Federal Government has elected to follow. For the dormant Commerce Clause, in both its interstate and foreign incarnations, only operates where the Federal Government has *not spoken* ...

829 P.2d at 292 (emphasis in original) (quoting *Wardair Canada v. Florida Dept. of Revenue*, 447 U.S. 1, 12 (1986)). A8.

3. *The Supreme Court of California*

Alcan filed a Petition for Review in the Supreme Court of California on July 23, 1993, which was denied without opinion on September 22, 1993, thereby rendering final the decision of the Court of Appeal in favor of Respondent, Franchise Tax Board.

REASONS FOR GRANTING THE WRIT OF CERTIORARI

I. INTRODUCTION.

The utilization of the unitary method of taxation has been a matter of international controversy since it was adopted and applied by California over a quarter of a century ago. This Court reviewed the application of this tax to domestic parent combinations in *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159 (1983). In that case, this Court explicitly excepted from its holding the question of whether the tax was unconstitutional as applied to foreign parent combinations. As a practical matter, a final resolution of this controversy has awaited a determinative statement by this Court concerning the constitutionality of this method of taxation. This case presents the opportunity to address this issue *both* with respect to whether the tax creates a substantial risk of multiple taxation and whether the tax prevents the Federal Government from "speaking with one voice" as outlined by this Court in *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434 (1979), as well as whether this tax conflicts with the constitutional standards of *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977).

II. PETITIONER'S WRIT SHOULD BE GRANTED BECAUSE THIS CASE PRESENTS FAR MORE ISSUES UNDER THE FOREIGN COMMERCE CLAUSE THAN WERE CONSIDERED BY THE CALIFORNIA SUPREME COURT IN *BARCLAYS BANK INTERNATIONAL, LTD. V. FRANCHISE TAX BOARD.*

In *Wardair Canada v. Florida Department of Revenue,* this Court noted that there were six critical questions in determining whether or not there was a violation of the foreign Commerce Clause:

> When a state tax is challenged as violative of the dormant Interstate Commerce Clause, we have asked four questions: is the tax applied to an activity with a substantial nexus with the taxing State; is the tax fairly apportioned; does the tax discriminate against interstate commerce; and is the tax fairly related to the services provided by the State. *Complete Auto Transit, Inc. v. Brady,* 430 U.S. 274, 279 (1977). In *Japan Line,* [441 U.S. 434, 451 (1978)], we noted that when the state tax allegedly interferes with the Federal Government's authority to regulate foreign commerce, two additional questions must be asked: "first, whether the tax, notwithstanding apportionment, creates a substantial risk of international multiple taxation, and, second, whether the tax prevents the Federal Government from speaking with one voice when regulating commercial relations with foreign governments."

477 U.S. 1, 8 (1986).

In *Barclays Bank International Ltd. v. Franchise Tax Board,* 829 P.2d 279 (1992), *cert. denied, Barclays Bank PLC v. Franchise Tax Board,* _____ U.S. _____, 113 S. Ct. 202 (1992) *cert. granted* (U.S. Nov. 1, 1993) (No. 92-1384), the California Supreme Court resolved the constitutional question by looking at essentially one issue; the "speaking with one voice" aspect of this six

part test. This resulted from the fact that the Bank was simply unable to present a factual context that was capable of demonstrating that WWCR offended numerous other elements of the six part test. By relying inappropriately on this Court's logic in *Wardair*, the *Barclays'* Court reasoned tautologically that Congress had approved the tax which thereby precluded Alcan from demonstrating that numerous other parameters in a complete dormant Commerce Clause analysis were offended by the tax as it applied to Alcan. The Third Appellate District holding that *Barclays'* controls in this case stated that:

> [W]here Congress has *not* acted to exercise its commerce clause power, the court is the final arbiter of the competing demands of state and national interests (*Barclays, supra,* 2 Cal. 4th at p. 722). For this task, the United States Supreme Court has adopted a six-part test to evaluate state tax schemes to ensure compliance with the inherent demands of the "unexercised" foreign commerce clause . . . [h]owever, as repeatedly emphasized by *Barclays,* where Congress *has* acted to exercise its commerce clause power, the "unexercised" commerce clause analysis does not apply.
>
> . . . [T]he *Barclays* court concluded the Bank's invocation of a [sic] "unexercised" commerce clause analysis was "inappropriate" (2 Cal. 4th at p. 727) because Congress had exercised its commerce clause power and decided not to prohibit state use of the WWCR method of taxation. (*Id.,* at pp. 726-741.)

Alcan Aluminum Corp. v. Franchise Tax Board, No. C011530, slip op. at 9-10 (Court of Appeal of the State of California, Third Appellate District, June 17, 1993. A8-9. As Petitioner will demonstrate, the *Barclays* Court improperly reasoned from *Wardair* the result of which was to again deny Alcan the opportunity to present the factual context of its case which has been pursued by it and its parent, Limited, through the courts for over a decade.

A. The California Supreme Court Incorrectly Presumed That Because *Barclays* Did Not Have A Factual Scenario That Demonstrated An Enhanced Risk Of Multiple Taxation That It Could Never Be Demonstrated.

The California Supreme Court in *Barclays* began its analysis by extrapolating from the reasoning of this Court and concluding that separate accounting could not, standing alone, impeach the use of the formulary method's accuracy in determining the tax. This Court has evolved a doctrine that makes it exceedingly difficult to demonstrate the existence of multiple taxation as a result of the use of WWCR. This does not mean that multiple taxation does not occur, nor that it is not massive in its impact. The problem results from the fact that this Court's logic is somewhat circular. If this Court fails to grant certiorari in this case, it will have precluded Alcan and presumably other foreign nationals from demonstrating the existence of multiple taxation as a result of WWCR simply because Barclays Bank, through no fault of its own, failed to do so.

The California Supreme Court in *Barclays* concedes that the unitary method of taxation can be constitutionally impeached if it can be shown that it "produce[s] an unreasonable result." 829 P.2d at 284 (quoting *Bass v. Tax Comm.*, 266 U.S. 271, 282-283 (1924)). The Court goes on to note that either AL/SA or WWCR is constitutionally permissible "as long as the [method] chosen does not operate 'unreasonably and arbitrarily' to attribute to the taxing state a percentage of total income 'out of all proportion to the business transacted by the [taxpayer] in that State.' " 829 P.2d at 285 (quoting *Hans Rees' Sons v. North Carolina*, 283 U.S. 123, 135 (1931)). However, after concluding that

Barclays failed to meet its burden in this respect, the California Supreme Court undertook to develop a doctrine that would effectively preclude every challenge to the tax regardless of the quality of the facts and the unreasonable and arbitrary nature of the tax by developing a doctrine that precludes consideration of the impact.

B. The Hallmark Of The Alcan Case Is That It Has The Factual Basis To Illustrate The Unreasonable And Arbitrary Nature Of WWCR Because It Can Convincingly Demonstrate That The Tax Assessed Against It Was Out Of All Proportion To Its Business In The State.

There is a simple reason why the AL/SA standard is the international standard. Since it is a market based standard, albeit not perfect, it is immune from the systematic manipulation of the party who stands to benefit from the formula's application. From the perspective of a multinational, Limited would have no objection to the use of a formula provided there was one agreed upon by all nations. The reason there is no agreement on a formula is because in the international context there are such great variations in economic systems and accounting standards that nations are unable to agree upon one. In a sense, the AL/SA standard has become the standard by default. The California Supreme Court took great pains to survey the history of this Court's comments on the legal equivalence of AL/SA with the formulary method. However, it was equally careful to articulate a doctrine which insures that contrary facts that might question the constitutional validity of WWCR in the foreign context, notwithstanding the fact that this Court reached its conclusions exclusively in the context of United States businesses, could never be considered.

Under the *Barclays* circumstances, it was impossible to demonstrate the extreme potential for massive double taxation for two reasons. First, *Barclays* had only a small portion of its potential WWCR liability at stake in the years at issue. Second, since separate accounting had been impugned as a basis for impeaching the unitary method, it left only rare instances in which the real economic impact of the tax might be demonstrated. The Alcan case presents just such an instance where the conclusion that WWCR was clearly taxing foreign income is inescapable. It was rare because the business operation had to be effectively destroyed in order to make the point. These facts present not only an opportunity for this Court to view in real economic terms the fundamental basis for the international objections to the tax, but also present this Court with an opportunity to reevaluate the limitations it has imposed on challenges to these taxes, and to develop a more realistic and fair standard for challenging such formulas in the foreign context.

The problem with the present state of the law with respect to impeaching formulas is that this Court does not present an objective standard upon which to evaluate a formula's fairness. The problem arises because this Court starts its reasoning with the proposition that formulas are justified because separate accounting permits companies to shift "undetectable"[2] sources of income in a manner that avoids taxation. However, as Sigmund Freud noted with respect to religion, this reasoning has the characteristic of being incapable of being proven or refuted:

---

[2] If these values were detectable and quantifiable, AL/SA could not be impeached since these values could simply be used to adjust the AL/SA result.

> Of the reality value of most of [religious beliefs] we cannot judge; just as they cannot be proved, so they cannot be refuted.

S. Freud, *Future of An Illusion,* 31 (1961).

The result is that the primary method for criticizing formula apportionment, separate accounting, becomes virtually useless because no matter how dramatic the difference between the AL/SA method and the WWCR method, the AL/SA method is suspect on the grounds that it is not accurately reflecting income since hidden values are escaping detection. This Court has reasoned in this vein in the past when it rejected an attack on a distorted formulary result. It concluded that since it had approved the formulary apportionment method because it believed that AL/SA missed significant but "unidentifiable" value, any distortion revealed by the AL/SA method must be suspect:

> In these circumstances [a unitary business], the Court has noted that separate accounting, while it purports to isolate portions of income received in various States, may fail to account for contributions to income resulting from functional integration, centralization of management, and economies of scale.

Mobil Oil Corp. v. Comm'r of Taxes, 445 U.S. 425, 438 (1980) (citing *Butler Bros. v. McColgan,* 315 U.S. 501, 508-509 (1942)).

Although it is true that a separate accounting method may not accurately measure these factors, it is equally true that it may. Since the present doctrine that this Court has adopted simply assumes that separate accounting never accurately measures these factors, any attempt to use it to impeach a formulary method is almost always destined for failure at the outset. This

case, however, presents a rare set of facts which shows the distorting effect of WWCR without reliance on AL/SA.

Alcan's franchise tax liability for the years in question arose primarily from the Riverside, California manufacturing operation. Alcan acquired the facility in 1965, along with assets in New York and New Jersey when it was formed by Limited. The Riverside facility was acquired from National Distillers and Chemical Corporation. At the time of its acquisition, the operation had been losing money on a separate accounting basis and was sold to Alcan at a market price that reflected that fact.

Alcan had great hopes that it could revive the facility and that it could be made profitable as a result of the expertise developed in the international sales and marketing operation of Limited.[3] Those hopes proved to be illusory. The facility continued to lose money as part of the Alcan operation and was finally closed in 1977. The Riverside facility was unquestionably an unprofitable operation in large measure due to its structure and organization. Early in Alcan's ownership, the United States Justice Department had concluded that Alcan's ownership of the Riverside facility raised antitrust concerns. The matter was resolved when Alcan entered into a consent decree to sell the facility. All of these events combined to independently confirm what the AL/SA numbers had, in fact, accurately represented as the actual economic status of Alcan's Riverside facility: California's formula was taxing the facility "out of all appropriate proportion to the business transacted . . . in that State." *Barclays,* 829 P.2d at 285 (quoting *Moorman Mfg. v. Bair,* 437 U.S. 267, 274 (1978)).

[3] This was, in a sense, a unitary operation in reverse where the California operation was to benefit from activities in other countries.

Alcan's attempts to sell the facility as required by the consent decree proved futile. It soon became apparent that the facility had no "going concern" value; that is the value which reflects the facility's ability to produce income. After making numerous efforts to sell the facility or make it profitable, Alcan management finally had to acknowledge that the facilities were simply incompatible with the reality of the contemporary marketplace. Managements' conclusions in this regard were recorded in the mid 1970's in the Request For Authorization to scrap the facility referred to in paragraph 14 of the Stipulation of Facts as Exhibit XXI:

> The Riverside sheet products operation has lost money in every year since 1972, averaging some $900,000 of loss before interest and tax per year during the last four years.
>
> The current Annual Plan predicts a loss of $1.3 million in 1976 and a further loss of $0.7 million next year (after interest but before tax). Sales and booking volumes are running about 10% under plan levels so a substantial additional loss, perhaps up to $0.2 million, can be anticipated . . .
>
> * * *
>
> With a few exceptions, the Riverside equipment is narrow and obsolete. Due to the growth pattern of the facility, the layout is inefficient and the "wide" casting and hot rolling line is too narrow even for double width siding. Any modernization program to increase width capabilities beyond 26" would have to embrace almost the entire plant and would probably cost as much as or more than starting on a green fields basis. The California market would not justify this sort of expenditure.

Stipulation of Facts, Exhibit XXI, *Alcan Aluminum Corp. v. Franchise Tax Board*, No. 322638 (Cal. Sup. Ct., County of Sacramento, May 31, 1991) A25, A26.

The theory of unitary taxation is that unitary businesses shift income in a way that does not accurately reflect the real earnings in the state. However, the foregoing example demonstrates the dramatic failure of that theory when applied in the context of a foreign parent combination. It is absolutely clear that both the independent market place and the company recognized that the facility was not profitable because it was "obsolete". It was also well understood that the nature of the California market made any additional investment uneconomical. Given these facts, it is patently clear that California's economic climate and the physical state of the facility made it impossible for the Riverside facility to ever operate in a fashion that would result in overall profitability. In fact, that is precisely what the separate accounting numbers demonstrated. The formulary method, however, treated the facility as though it was highly profitable when it was, in fact, clearly losing money.

If Alcan had not been under an obligation to put the property on the market, the evidence that it had no going concern value independent of AL/SA, would not have been available. If the facility had not in fact been unprofitable, but instead had produced a reasonable income, just not nearly as much as the formulary method attributed to it, then Alcan would not have closed the facility. Under these circumstances and under the California Supreme Court's interpretation of this Court's reasoning, there would have been no basis to impeach the formulary method, even though the distorting effects of the tax might even have been more severe. Thus, in *Barclays,* when the Bank was unable to demonstrate that the tax was excessive when related to its activities in California, it was not because that was not true, but

simply because, through no fault of its own, it did not have the facts that Alcan had experienced through a series of different events.

Not only does this case present the facts that highlight the real impact of WWCR, but it also demonstrates that the formula-generated tax is being imposed upon income generated wholly outside the United States, which was already subject to taxation by the nation in which it was earned.

C. This Case Also Demonstrates Why AL/SA And WWCR Are Not Substantive Equivalents Simply Because Neither Are Perfect.

The California Supreme Court in *Barclays* lifted this Court's statements from *Container Corp.* to conclude that since both AL/SA and WWCR could result in double taxation, the two methods are substantively interchangeable in all situations:

> [This Court] first noted that 'allocating income among various jurisdictions bears some resemblance . . . to slicing a shadow,' and concluded that 'it would be perverse, simply for the sake of avoiding double taxation, to require California to give up one allocation method that sometimes results in double taxation [i.e., formula apportionment] in favor of another allocation method [i.e., AL/SA] that also sometimes results in double taxation.'

Barclays, 829 P.2d at 288 (quoting *Container Corp.*, 463 U.S. at 192-193).

This reasoning is flawed. There is very little in life that operates perfectly in practice; however, there are very significant distinctions that can be made on the underlying theory and the empirical evidence that supports a particular allocation scheme. For example, as

an economic issue there is no fundamental economic difference between *Container Corp.* and *Mobil Oil.* Both involved the allocation of United States value. The fact that the foreign dividends in *Container Corp.* had not been repatriated as an accounting event does not change the fundamental economic nature of the case since the value of those dividends was immediately reflected in the increased net worth of the parent, Container Corporation. Thus, the substantive equivalence of the formulary method and the AL/SA method in *Container Corp.* was in the context of a single United States economic climate to which both methods had demonstrated a reasonable empirical and theoretical relevance. What the Riverside example illustrates is what occurs when WWCR is applied in a context where the formula has not been demonstrated to have the same relevance in terms of how income is generated among widely varied economic cultures. Clearly, the more socialistic the system, the less relevant payroll becomes in reflecting profit generation.

AL/SA is imprecise in its allocation of income between nations but that imprecision stems from the imperfection in measurement not the irrelevance of the allocation scheme. The California Supreme Court treats measurement imperfection as the substantive equivalent of a method of allocation for legal purposes and that, in Alcan's view, is both a legal and common sense mistake.

The fallacy in the California Supreme Court's logic might be illustrated by reference to the physical sciences. High school and college physics courses teach that there are two well-known methods of explaining how matter behaves. On the macro-level, there are the well-known principles of Newtonian mechanics. At the subatomic particle level, however, there are principles referred to as Quantum mechanics. Even though both disciplines

describe relationships between the same matter, the principles of each discipline are distinctly different. These principles are expressed by formulas similar in kind to apportionment formulas.

In measuring physical events in both macro and subatomic levels, the instrumentation is by its nature inaccurate. Obviously, improvements have taken place over time, but nothing is perfect. However, it would be highly inappropriate to use a Newtonian formula to explain a subatomic event simply because the instrumentation is inaccurate. Quantum mechanics was developed because it became clear by empirical investigation that Newtonian mechanics did not explain subatomic events even if there might be some superficial similarity. Thus, a formula which explains what happens with the cue ball on a billiard table on the break shot of a game, is not appropriate for explaining what happens when protons are accelerated into an atomic nucleus.

Similarly, from an economic perspective, a formula which relies on wage rates, capital (property) costs and the market value of sales in a third world country where labor is very cheap and used instead of capital and the cost of living is very low, will have equally as little relevance to how profits are generated as the cue ball formula does to the atomic nucleus. The Riverside example illustrates these facts.

D. Petitioner's Writ Of Certiorari Should Be Granted Because The California Supreme Court Clearly Misunderstood This Court's Reasoning In *Wardair Canada V. Florida Department Of Revenue* And Precluded Alcan From Ever Presenting Its Evidence Of Multiple Taxation.

It has been the hallmark of Alcan's case that WWCR violates the Commerce Clause because it offends the principles that this Court enunciated in *Complete Auto* and *Japan Line*. This case presents the factual context to illustrate that fact. The California Supreme Court has refused to consider Alcan's facts because it held, in effect, that since Congress failed to explicitly prohibit that which might otherwise be prohibited as a matter of law, Congress really has permitted the activity. This peculiar logic is predicated on a clear misreading of *Wardair*. In *Wardair*, this Court did not conclude that a dormant Commerce Clause analysis was not appropriate because Congress had acted to permit the tax. Rather, this Court concluded that the case was not appropriate for a dormant Commerce Clause analysis because both of the parties agreed that none of the elements for such an analysis existed:

> In the present case, appellant concedes that Florida's tax satisfies the four-part test set out in *Complete Auto*. In other words, it is not disputed that if this case did not involve foreign commerce, the Florida tax on the sale of aviation fuel would not contravene the Commerce Clause. Appellant also recognizes that there is no threat of multiple international taxation in this case, since the tax is imposed only upon the sale of fuel, a discrete transaction which occurs within one national jurisdiction only. Appellant and the United States as *amicus curiae* thus rely entirely on the final factor identified in *Japan Line*, and argue that the

> Florida tax violates the Foreign Commerce Clause because it threatens the ability of the Federal Government to 'speak with one voice.'

Wardair, 477 U.S. at 8-9.

It is one thing to say that an otherwise completely constitutional tax is not unconstitutional because the Federal Government has not acted in a way that convincingly suggests that the tax interferes with its foreign relations, and even appears to countenance the tax by a failure to prohibit it. That is essentially a proof issue and this Court concluded that *Wardair* failed to meet its burden to establish a federal policy. It is quite another thing, however, to suggest that the failure of the Federal Government to act to prohibit a tax that is otherwise illegal because it offends the elements of *Complete Auto* can be converted to the legal equivalent of a statutory expression by the Congress and the Executive that the tax has been authorized. That is precisely what the California Supreme Court did in *Barclays* and this Court should review its action for two reasons. First, it clearly conflicts with this Court's explicit requirement that Congress may only permit activities that would otherwise offend the Commerce Clause by explicit statutory action even when it appears to be consistent with United States policy. In reviewing an Iowa unitary tax scheme which discriminated against foreign commerce by including foreign dividends in the tax base and not including dividends from United States subsidiaries, this Court held that absent explicit statutory authorization, the tax cannot avoid a Commerce Clause analysis even if it is otherwise consistent with United States policy:

> Iowa need not adopt the federal definition of taxable income. Nor, having chosen to follow the federal system in part, must Iowa duplicate that scheme in

> all respects. The adoption of the federal system in whole or in part, however, cannot shield a state tax statute from Commerce Clause scrutiny. The Iowa statute cannot withstand the scrutiny, for it facially discriminates against foreign commerce and therefore violates the Foreign Commerce Clause.

Kraft Gen. Foods, Inc. v. Iowa Dep't of Revenue and Fin., _____ U.S. _____, 112 S. Ct. 2365, 2372 (1992).

Second, the California Supreme Court's decision sets a dangerous precedent because it permits courts to insert their judgments as to why Congress did not act and convert that judgment to the equivalent of legislation. This is not only judicial legislation in its grossest form, it takes the entire notion of courts usurping the role of the Legislature a step further by permitting a state court to elevate its judgment to the legal equivalent of a federal statute.

III. THE CALIFORNIA SUPREME COURT'S CONCLUSION THAT THERE IS A FEDERAL POLICY PERMITTING THE TAX IS NOT SUPPORTED BY THE OVERWHELMING EVIDENCE.

It should be clear to this Court from the foregoing that AL/SA, which this Court acknowledged in *Container Corp.*, is the international standard. That is not as much a matter of choice as it is of necessity. Since nations are unable to agree on a formula, the AL/SA method which relies on the market place as the ultimate arbiter of where profits are earned becomes the policy of nations by default as well as by choice. The lower courts in these cases have had numerous nations, including the United States, appear before them in both the *Alcan* and *Barclays* cases and insist that their common understanding of United States policy is that federal taxation of subsidiaries of foreign nations must be limited to the AL/SA standard.

The California Supreme Court's conclusion in *Barclays* that Congress' failure to explicitly prohibit the tax means Congress intended to approve it is flawed. There are numerous other more plausible explanations for congressional inaction. One of the most obvious is that there is no need to prohibit that which is already illegal. The Federal Government's explicit statement of intent to pursue the matter through the courts certainly supports that view. *See* Joint Report by Inland Revenue and U.S. Treasury, Unitary Tax, December, 1991 Report, reprinted in Appendix at A28-A48. Further, if congressional silence is the equivalent of implicit authorization, there would *never* be a need to perform a dormant Commerce Clause analysis.

The facts do not support the position of the California Supreme Court that the failure of article 9(4) of the United States-United Kingdom treaty indicates that Congress intended to permit the tax. *See Barclays,* 829 P.2d at 294. It is quite clear that there were never enough votes to pass a statutory authorization for the tax as illustrated by the small margin by which the treaty provision failed to get the required two-thirds vote. Moreover, the California Supreme Court tragically misinterprets the restrained attempts by the Federal Government to persuade California to get in line with the international community as a sign that the tax is condoned. The California Supreme Court seems to be saying that all they respond to is force.

Finally, the California Supreme Court's reliance on *Wardair* is misplaced. In that case, it was clear that the tax involved was a perfectly appropriate tax absent a clear and explicit preclusion by federal action. These facts are dramatically different. Here it is clear that foreign income is pulled into the California tax base to determine the California liability. The unitary tax theory is not limited to taxing a discrete event in the state, but determining the liability of the entire international business to California. Under the circumstances there is no support for the notion that California's characterization of federal policy is correct.

CONCLUSION

For all of the foregoing reasons, Alcan respectfully requests that this Honorable Court issue a Writ of Certiorari to the Court of Appeal of the State of California in and for the Third Appellate District.

Respectfully submitted,

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APPENDIX

OPINION OF THE COURT OF APPEAL OF THE STATE OF CALIFORNIA, THIRD APPELLATE DISTRICT

(Filed June 17, 1993)

NOT TO BE PUBLISHED

C011530
(Super.Ct.No. CV322638)

IN THE COURT OF APPEAL OF THE
STATE OF CALIFORNIA
THIRD APPELLATE DISTRICT
(Sacramento County)

ALCAN ALUMINUM CORPORATION,
Plaintiff and Appellant,

v.

FRANCHISE TAX BOARD,
Defendant and Respondent.

Plaintiff, an Ohio corporation which manufactures and sells aluminum products nationally and conducts a portion of its business in California, is a wholly-owned subsidiary of Alcan Aluminium Limited (Alcan), a Canadian corporation. Defendant Franchise Tax Board (the Board) determined that plaintiff was part of Alcan's unitary enterprise and calculated plaintiff's California tax liability using the "worldwide combined reporting" (WWCR) method of taxation. (See, e.g., Barclays Bank Internat., Ltd. v. Franchise Tax Bd. (1992) 2 Cal.4th 708,

714-717.)[1] Plaintiff timely protested all tax assessments made pursuant to the WWCR method and brought this action for refund of taxes it allegedly overpaid.

Plaintiff claimed the Board's use of the WWCR method of taxation violates the foreign commerce clause of the United States Constitution. (U.S. Const., art. I, §8, cl. 3.) At trial, the parties stipulated that plaintiff's action presented only two issues: whether the WWCR method contravenes two of the six criteria developed by courts to evaluate state tax schemes to ensure compliance with the inherent demands of the foreign commerce clause of the federal Constitution which limits state action affecting commerce when Congress has not exercised its plenary commerce power. (See, e.g., *Barclays*, supra, 2 Cal. 4th at pp. 722-723 [where Congress has not exercised its plenary commerce clause power, the courts have adopted a six-part test to determine whether state tax schemes comply with the inherent demands of the "unexercised" foreign commerce clause: (1) is the tax applied to an activity with a substantial nexus with the taxing state, (2) is the tax fairly apportioned, (3) does the tax discriminate against interstate commerce, (4) is the tax fairly related to services provided by the state, (5) does the tax,

[1] The WWCR method utilizes a mathematical formula to combine and apportion the worldwide income of multinational corporate taxpayers to determine state taxable income or value. The formula distributes "an aliquot share of income or taxable value among taxing jurisdictions. The dominant variation of formula apportionment—the so-called 'three-factor' model employed by the Board in this case—defines the multijurisdictional scope of the unitary enterprise of which the taxable intrastate activities are a part, calculates the combined income of the components of the unitary group, and distributes a portion of that result to the taxing state using a mathematical formula based on an averaged ratio of property, payroll, and sales in the taxing jurisdiction to that of the unitary enterprise overall." (*Barclays*, supra, 2 Cal. 4th at p. 715, fn. omitted.)

notwithstanding apportionment, create a substantial risk of international multiple taxation, and (6) does the tax prevent the federal government from "speaking with one voice" when regulating commercial relations with foreign governments?].)

The two criteria raised by plaintiff are whether the WWCR method "impermissibly prevents the federal government from speaking with one voice or impermissibly gives rise to either the risk of or actual multiple taxation." Plaintiff disavowed any claim that the WWCR method violates the due process clauses of the federal and state Constitutions.

Regarding its "speaking with one voice" contention, plaintiff intended to argue that the WWCR method is invalid because it causes foreign-owned multinational corporations to incur compliance expenses which the federal government, by treaty, has agreed it would not impose. Plaintiff planned to present evidence of its compliance expenses at trial. However, the Board moved in limine to exclude that evidence on the grounds plaintiff did not raise the compliance expense issue in its claims for tax refunds and did not present any evidence of its compliance expenses during the administrative hearing.

The trial court ruled that plaintiff adequately raised the compliance expense issue in its refund claims but "[f]ailed to exhaust its administrative remedies by failing to present to [the Board] during the administrative process any factual evidence as to what its costs of compliance were or would be." The court then determined that the federal government "has affirmatively acted to allow the states to use [the WWCR method] at least until Congress passes legislation to the contrary." Having so concluded, the

court found it unnecessary to reach the question whether the WWCR method would be constitutional under the "unexercised" commerce clause analysis which would have applied in the absence of such Congressional action. Plaintiff appealed.

In its original briefs filed while *Barclays* was pending before the California Supreme Court, plaintiff argued: (1) the trial court erred in ruling that plaintiff failed to exhaust its administrative remedies as to its claim concerning costs of compliance, (2) the court erroneously determined that the federal government has permitted states to use the WWCR method, and (3) the judgment must be reversed because the WWCR method is invalid under an "unexercised" foreign commerce clause analysis.

Barclays, decided in May 1992, holds that California's use of the WWCR method of taxation does not violate the foreign commerce clause of the federal Constitution because Congress has exercised its plenary commerce power and has decided not to prohibit state use of the WWCR method. (2 Cal.4th at pp. 712, 733, 742.) Since Congress has acted affirmatively to permit states to employ the WWCR method of taxation, *Barclays* concluded that an "unexercised" foreign commerce clause analysis is not applicable because such analysis is used only where Congress has failed to exercise its commerce power. (*Ibid.*)

Having asked the parties to provide supplemental briefing on how *Barclays* affects this case, we shall conclude that *Barclays* and this court's subsequent decision in Barclays Bank Internat. Ltd. v. Franchise Tax Bd. (1992) 10 Cal.App.4th 1742 (*Barclays II*) defeat plaintiff's claims of reversible error. Accordingly, we shall affirm the judgment.

FACTS

At trial, the parties executed a lengthy stipulation of facts and issues which we summarize briefly. Plaintiff was a New York corporation during the tax years in question and is now an Ohio corporation. Plaintiff is a wholly owned subsidiary, directly or indirectly, of Alcan. Alcan has nearly 100 other subsidiaries scattered around the world. It is conceded that Alcan and all of its more-than-50-percent owned subsidiaries, including plaintiff, constitute a "unitary business."

For tax years 1972 through 1974, plaintiff originally filed California tax returns which reflected its individual activities. The Board audited plaintiff's tax returns and determined that plaintiff is part of the unitary business conducted by Alcan. The Board calculated plaintiff's tax liability on an apportioned share of the total business income of the unitary business. Using that method, the Board determined plaintiff owed additional taxes. Plaintiff paid the additional taxes, pursued its administrative remedies with the Board, and initiated refund suits as authorized by law.

The parties stipulated that plaintiff's action involved two legal issues: "For the purposes of this litigation, these parties hereby stipulate that the only legal issues before this Court are whether the Board's application of the unitary method of accounting under Section 25101 *et seq.* of the California Revenue and Taxation Code, and implementing regulations, as applied to the facts in this case violated the Foreign Commerce Clause of the United States Constitution in that such application impermissibly prevents the federal government from speaking with one voice or impermissibly gives rise to either the risk of or actual multiple taxation. For purposes of this litigation, Alcan is not contesting the

Board's determination that the Alcan Group Companies constitute a single unitary business under the tests formulated by the California Courts and the United States Supreme Court, or contending that the tax assessed violated the Due Process Clauses of the United States Constitution or the California Constitution."

DISCUSSION

I

Because this case is controlled by *Barclays*, our discussion begins with a summary of that decision.[2] In *Barclays*, the Board found that the taxpayers, Barclays Bank of California and Barclays Bank International, Ltd. (collectively, the Bank), together with its United Kingdom-based corporate parent and related worldwide subsidiaries, constituted a unitary enterprise, thereby subjecting the Bank to the WWCR method used by the Board to apportion the interjurisdictional income of a unitary business for state corporate income tax purposes. (2 Cal.4th at pp. 712-713; see fn. 1, *ante*.) The Bank contested the Board's action, claiming application of California's apportionment formula to a unitary group whose corporate parent is a foreign domiciliary violates the foreign commerce clause of the federal Constitution. (*Id.*, at p. 713.) The California Supreme Court disagreed.

Barclays explained that controversies, like this one, over the method by which states tax businesses operating in more than one jurisdiction arise from "the stricture of the commerce and due process clauses of the federal Constitution that 'a State may not tax value

[2] We do so without elaborating on the United States Supreme Court precedents relied upon by *Barclays* and without setting forth in detail the analysis by which the court in *Barclays* arrived at its conclusions. We direct the parties to the *Barclays* opinion for that detail.

earned outside its borders.' " (2 Cal.4th at p. 714, quoting ASARCO Inc. v. Idaho State Tax Comm'n (1982) 458 U.S. 307, 315 [73 L.Ed.2d 787, 794].) "To meet this limitation, state tax schemes must comply with multiple criteria designed to produce a substantially accurate distribution of income so that only 'values created by business within its borders' are taxed." (*Id.*, at pp. 714-715, quoting Butler Brothers v. McColgan (1942) 315 U.S. 501, 507 [86 L.Ed. 991, 996].)

Citing United States Supreme Court precedent, *Barclays* rejected the Bank's claim that the WWCR method of taxation is an inherently inequitable method when applied to foreign-based unitary groups such as the Bank and its affiliates. (2 Cal.4th at pp. 720-721.)

Barclays then proceeded to determine whether the WWCR method violates the foreign commerce clause of the federal Constitution. The court observed that, in order to determine this question, one first must look to see if Congress has acted to exercise it plenary commerce clause power with respect to state use of the WWCR method of taxation. If so, the issue then is whether Congress, in so acting, has decided to prohibit or not to prohibit use of that method. (2 Cal.4th at pp. 722, 728-733.) If Congress has *not* exercised its commerce clause power, the focus shifts to whether the WWCR method of taxation violates the foreign commerce clause's inherent limitation upon the power of the states. This is so because it long has been accepted constitutional doctrine that, even without the aid of Congressional action, the commerce clause affords some protection from state legislation which is inimical to the national commerce. This doctrine commonly is known as the "unexercised" or "dormant" commerce clause. (*Id.*, at p. 722.)

Thus, where Congress has *not* acted to exercise its commerce clause power, the court is the final arbiter of the competing demands of state and national interests. (*Barclays,* supra, 2 Cal.4th at p. 722.) For this task, the United States Supreme Court has adopted a six-part test to evaluate state tax schemes to ensure compliance with the inherent demands of the "unexercised" foreign commerce clause: (1) is the tax applied to an activity with a substantial nexus with the taxing state, (2) is the tax fairly apportioned, (3) does the tax discriminate against interstate commerce, (4) is the tax fairly related to services provided by the state, (5) notwithstanding apportionment, does the tax create a substantial risk of international multiple taxation, and (6) does the tax prevent the federal government from "speaking with one voice" when regulating commercial relations with foreign governments? (*Id.,* at p. 723.)

However, as repeatedly emphasized by *Barclays,* where Congress *has* acted to exercise its commerce clause power, the "unexercised" commerce clause analysis does not apply. (2 Cal.4th at pp. 725, 730, 733.) " 'It would turn the dormant Commerce Clause analysis entirely upside down' . . . 'to apply it where the Federal Government has acted, and to apply it in such a way as to *reverse* the policy that the Federal Government has elected to follow. For the dormant Commerce Clause, in both its interstate and foreign incarnations, only operates where the Federal Government has *not spoken* . . . .' " (*Id.,* at p. 730, emphasis in original, quoting Wardair Canada v. Florida Dept. of Revenue (1986) 477 U.S. 1, 12 [91 L.Ed.2d 1, 12].)

Applying these principles of commerce clause jurisprudence to California's WWCR method of taxation, the *Barclays* court rejected taxpayer Bank's contention

that the Board's use of the WWCR method offended the "unexercised" foreign commerce clause because the method allegedly is contrary to policies expressed by the executive branch of the federal government. After examining a compilation of Congressional and executive materials, as well as international agreements, the *Barclays* court concluded the Bank's invocation of a [sic] "unexercised" commerce clause analysis was "inappropriate" (2 Cal.4th at p. 727) because Congress had exercised its commerce clause power and decided not to prohibit state use of the WWCR method of taxation. (*Id.*, at pp. 726-741.) It follows that, because Congress has decided to permit California to use of the WWCR method, this method does not violate the foreign commerce clause. (*Id.*, at pp. 741-742.)

The *Barclays* court cautioned that its "holding does not end the matter, however. The trial court [in *Barclays*] held that the cost to a foreign-based unitary enterprise of furnishing financial data requested by the Board's use of the [WWCR] method—the so-called 'compliance burden'—violated due process. . . . The Court of Appeal explicitly declined to decide the due process issue . . . a fact-dependent question that should be decided by the Court of Appeal in the first instance . . . ." (2 Cal.4th at p. 742.) Hence, the Supreme Court remanded the case to this court for further proceedings consistent with the *Barclays* opinion. (*Id.*, at p. 743.)

In *Barclays II*, supra, 10 Cal.App.4th 1742, this court addressed not only the due process issue but also a claim that the "compliance burden" of California's WWCR method violates a component of the "unexercised" foreign commerce clause analysis. *Barclays II* held that the taxpayer's cost of complying with the WWCR method is *not* unconstitutionally

unreasonable, undue or arbitrary. (*Id.*, at p. 1756.) "The California WWCR unitary tax method does not discriminate against foreign-based unitary groups . . . Under that method, both groups are treated the same—they face the same tax rate and must furnish the same kind of information. [Citations.] . . . Therefore, a foreign-based multijurisdictional enterprise, in complying with a particular jurisdiction's taxation scheme, must always present its tax information in the language, currency and accounting principles the authorities in that jurisdiction understand. This does not constitute a *direct* commercial advantage to unitary groups based in that jurisdiction. At most, it constitutes an indirect cost inherent in doing business in *foreign* lands. (*Id.*, at p. 1753, emphasis in original.) *Barclays II* further concluded that the WWCR compliance process has reasonably adequate standards to guide enforcement. (*Id.*, at pp. 1756-1766.) Accordingly, *Barclays II* concluded that the administrative burden to taxpayers in complying with the WWCR method does not violate an "unexercised" foreign commerce clause analysis and does not violate either federal or state due process of law. (*Id.*, at pp. 1766-1767.)

With this decisional background, we turn to plaintiff's contentions.

II

Plaintiff first contends the trial court erroneously excluded evidence of its costs of compliance with the WWCR method on the ground plaintiff did not exhaust its administrative remedies on that issue. We need not address the merits of this contention because, in light of the rulings in *Barclays* and *Barclays II*, any error could not have been prejudicial.

Plaintiff intended to argue that the WWCR method impaired the federal government's ability to "speak with one voice" (Japan Line, Ltd. v. County of Los Angeles (1979) 441 U.S. 434, 451 [60 L.Ed.2d 336, 349]; *Barclays*, supra, 2 Cal.4th at p. 723) because, according to plaintiff, it "requires foreign multinationals to comply with the [the WWCR method] taxing scheme, even though the federal government, by treaty, has agreed it would not impose such costs of compliance." Plaintiff sought to support its argument with evidence of the costs it incurred or would incur in complying with the WWCR method. In response, the Board moved in limine for an order that plaintiff "may not present . . . any evidence concerning costs of compliance with California law regarding formula apportionment of income of a unitary business" on the grounds the "cost of compliance was not raised in the claims for refund," and "no evidence was ever presented to the department during the administrative process as to what the cost of compliance had been."

The trial court granted the Board's motion on the ground plaintiff "fail[ed] to exhaust its administrative remedies by failing to present to [the Board] during the administrative process any factual evidence as to what its costs of compliance were or would be." The trial court perceptively added: "This ruling is actually of no consequence to the outcome of this action because . . . the Court was not required to reach the issue of the burden of the disputed tax method on foreign commerce."

The trial court's latter observation was correct. The excluded evidence purportedly was relevant to show that, by imposing a compliance burden which the federal government asserted it would not impose, California

impaired the federal government's ability to "speak with one voice." However, as plaintiff concedes in its supplemental briefing, *Barclays* has resolved the "speaking with one voice" issue adversely to plaintiff by holding that an "unexercised" foreign commerce clause analysis, of which the "one voice" inquiry is a part, is not applicable to the WWCR method because Congress has exercised its commerce clause power and has decided to permit states to use the WWCR method of taxation. (2 Cal.4th at pp. 712, 733, 742.)

Because the *Barclays* holding is based on Congressional approval of the WWCR method of taxation, an issue to which the excluded evidence concerning "compliance burden" did not relate, the evidence could not have produced a different result. Hence, any error in excluding the evidence was necessarily harmless. (People v. Watson (1956) 46 Cal.2d 818, 836.) In any event, as noted in part I, *ante*, this court has concluded that the "compliance burden" of the WWCR method does not violate the foreign commerce clause. (*Barclays II*, supra, 10 Cal.App.4th at pp. 1766-1767.)

III

The remainder of the contentions in plaintiff's original briefs all relate to its claim that California's WWCR method of taxation violates article I, section 8, clause 3 of the United States Constitution based on an "unexercised" foreign commerce clause analysis. The contentions fail because (1) some of the arguments are beyond the parties' trial court stipulation and, thus, are not properly before us, and (2) all of the contentions are based on an "unexercised" foreign commerce clause analysis which, as we have noted in parts I and II, *ante*,

is inapplicable to the WWCR method since Congress has exercised its plenary commerce clause power and has decided to allow states to use the WWCR method of taxation. (*Barclays,* supra, 2 Cal.4th at pp. 712, 733, 742.)

Thus, we reject plaintiff's argument that the WWCR method violates the foreign commerce clause because it imposes an undue administrative burden on the taxpayer. Plaintiff claims this burden offends the principles of *Japan Line,* supra, 441 U.S. 434 [60 L.Ed.2d 336], presumably for the same reason plaintiff articulated in the trial court: because it impairs the federal government's ability to "speak with one voice." However, the "one voice" inquiry is part of an "unexercised" commerce clause analysis which does not apply to the WWCR method.

For the same reason, we reject plaintiff's contention that the WWCR method violates the foreign commerce clause because it results in "actual double taxation" of foreign-parent corporations. The double taxation inquiry, like the "one voice" inquiry, is part of the inapplicable six-factor "unexercised" commerce clause analysis.

In a lengthy argument, plaintiff contends the WWCR method violates the foreign commerce clause because it constitutes a tax on plaintiff's corporate parent, Alcan. Plaintiff argues that activities undertaken by other Alcan subsidiaries operating exclusively in foreign countries which serve to make those subsidiaries (and ultimately Alcan itself) more profitable, have the effect of raising plaintiff's (and Alcan's) California tax liability. It follows, plaintiff argues, by using the WWCR method, California is taxing Alcan's out-of-state activities. Plaintiff does not identify precisely how this feature of the WWCR method violates the foreign

commerce clause. However, at several points in the argument, plaintiff refers to "double taxation." Thus, the contention fails because plaintiff apparently is relying on the double taxation inquiry of the inapplicable "unexercised" foreign commerce clause analysis.[3]

Likewise, we reject plaintiff's contention that the WWCR method violates the foreign commerce clause because the tax is not fairly apportioned. Aside from the fact that the "fair apportionment" issue was not among the stipulated issues in this case and, thus, is not properly before us, the contention is based on the inapplicable "unexercised" foreign commerce clause analysis.

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[3] Plaintiff's argument could be construed as suggesting the WWCR method violates the foreign commerce clause because it taxes overseas events, i.e., activities lacking any substantial nexus with the taxing state. (*Barclays*, supra, 2 Cal.4th at p. 723.) This argument would fail for both procedural and substantive reasons. First, the parties stipulated in the trial court that only two of the six "unexercised" commerce clause factors are at issue in this case; the "substantial nexus" factor is not one of them. A stipulation in proper form is binding on both the parties and the court. (See, e.g., Palmer v. Long Beach (1948) 33 Cal.2d 134, 141; Capital National Bank v. Smith (1944) 62 Cal.App.2d 328, 343; 1 Witkin, Cal. Procedure (3d ed. 1985) Attorneys, §208 p. 239.) Plaintiff may not advance issues which have been excluded from the case by stipulation, and the court may not dispose of the case on the basis of excluded issues. (*Ibid.*) Second, the "substantial nexus" issue, like the double taxation inquiry, is a part of the "unexercised" commerce clause analysis which is inapplicable to the WWCR method.

Plaintiff's argument also could be construed as suggesting that, by taxing income earned outside California's borders, the WWCR method violates due process of law. (See *Barclays*, supra, 2 Cal.4th at p. 714.) However, plaintiff has stipulated that due process is not an issue in this case. We shall not consider it further. (*Palmer*, supra, 33 Cal.2d at p. 141; *Capital National Bank*, supra, 62 Cal.App.2d at p. 343.)

VI

We turn to plaintiff's supplemental briefing. Plaintiff acknowledges that the "California Supreme Court in *Barclay's* [*sic*] decided . . . the [Board's] use of [the WWCR method] is not inconsistent with United States foreign policy." Nevertheless, plaintiff contends this holding does "not end the inquiry as to whether the use of [the WWCR method] by states is permitted by the Constitution. [¶] The California Supreme Court has acknowledged this principle by concluding that the fact that the principle of 'speaking with one voice,' as enumerated in [*Japan Line*], is not violated 'does not end the matter . . . .' [Citation.] Referencing [Complete Auto Transit, Inc. v. Brady (1977) 430 U.S. 274 [51 L.Ed.2d 326]], the California Supreme Court noted that regardless of the one-voice issue, the states are not empowered to enact a tax which burdens foreign commerce."

Plaintiff misinterprets *Barclays*. As we have noted, *Barclays* holds that Congress has exercised its plenary commerce clause power and has decided to allow the states to apply the WWCR method. Because Congress has done so, we need not evaluate that method under the "unexercised" commerce clause factors of *Complete Auto Transit* and *Japan Line*. In the words of the *Barclays* court, "Congress's refusal to legislate restrictions on state use of worldwide formula apportionment is not the sort of governmental silence that triggers a dormant foreign commerce clause analysis." (2 Cal.4th at p. 742.)

Barclays notes its holding "does not end the matter," but not for the reason plaintiff suggests. In addition to raising a commerce clause challenge, the taxpayer in *Barclays* claimed its burden of complying with the WWCR method violated due process of law. The

trial court accepted that contention, but this court expressly declined to reach the issue. *Barclays* stated: "The due process issue is a fact-dependent question that should be decided by the Court of Appeal in the first instance; moreover, we think its examination of the issue would profit from a consideration of its merit free of the view that a dormant foreign commerce clause analysis is appropriate in the circumstances present here." (2 Cal.4th at p. 742.)

No such analysis is necessary in this case because plaintiff did not raise a due process challenge to the WWCR method.

Citing the recent decision in Kraft Foods v. Iowa Dept. of Rev. (1992) 505 U.S. _____ [120 L.Ed.2d 59], plaintiff claims the four-factor *Complete Auto Transit* test is not limited to "unexercised" commerce clause cases. *Kraft* does not support this claim. The case involved an Iowa statute which taxed the dividend income which corporations receive from their foreign subsidiaries but did not tax the dividend income they receive from their domestic subsidiaries. (505 U.S. at p. _____ [120 L.Ed.2d at p. 64].) Citing *Japan Line*, the *Kraft* court invalidated the tax, stating Iowa's "preference for domestic commerce over foreign commerce is inconsistent with the Commerce Clause . . . ." (*Id.*, at pp. _____ [120 L.Ed.2d at pp. 67-68].) Plaintiff correctly notes the "discrimination against foreign commerce" factor discussed in *Kraft* is part of the *Complete Auto Transit/Japan Line* "unexercised" commerce clause analysis. However, plaintiff fails to recognize that *Kraft* is an "unexercised" commerce clause case. *Kraft* does not suggest that Congress

authorized Iowa's taxing scheme[4] or that a *Complete Auto Transit/Japan Line* analysis would have been appropriate had such authorization been given. *Kraft* is not authority for a point it did not discuss. (People v. Superior Court (Marks) (1991) 1 Cal.4th 56, 65-66; Brown v. Kelly Broadcasting Co. (1989) 48 Cal.3d 711, 734-735.)

Even if, as plaintiff claims, the *Complete Auto Transit* factors apply in exercised foreign commerce clause cases, the contentions raised in plaintiff's supplemental briefing may not be considered in this appeal. Plaintiff contends the WWCR method produces a tax which is not sufficiently connected to the taxing state and not fairly related to the benefits the state provides to the taxpayer. In the language of *Complete Auto Transit*, plaintiff argues the tax lacks a substantial nexus with the taxing state. Plaintiff also contends the WWCR method discriminates against international commerce because it imposes undue compliance costs. Finally, plaintiff claims the WWCR method produces a tax that is not fairly apportioned. These contentions implicate three of the six factors used by courts in an "unexercised" commerce clause analysis. (*Barclays*, supra, 2 Cal.4th at p. 723.) However, these factors are outside the scope of plaintiff's stipulation, i.e., that this action presents only two issues: "whether the unitary method . . . as applied to the facts in this case violated the Foreign Commerce Clause of the United States

[4] Plaintiff argues the federal government authorized Iowa's tax because the United States appeared in the case as amicus curiae for Iowa. However, it is the executive department, not Congress, which selects the cases in which the United States appears as amicus curiae. Such an appearance does not denote Congressional approval, for it may "embody nothing more than executive aspirations of what the federal government's policy in this area *ought* to be." (*Barclays*, supra, 2 Cal.4th at p. 734, emphasis in original.)

Constitution in that such application impermissibly prevents the federal government from speaking with one voice or impermissibly gives rise to either the risk of or actual multiple taxation." Because the contentions in plaintiff's supplemental briefing raise issues outside the scope of the parties' stipulation of issues, they may not be considered in this appeal. (*Palmer*, supra, 33 Cal.2d at p. 141; *Capital National Bank*, supra, 62 Cal.App.2d at p. 343; 1 Witkin, op. cit. supra, §208, p. 239.)

DISPOSITION

The judgment is affirmed.

SCOTLAND, *J.*

We concur:

DAVIS, Acting *P.J.*
NICHOLSON, *J.*

3 Civil C011530
Sacramento CV322638

IN THE

COURT OF APPEAL OF THE
STATE OF CALIFORNIA

IN AND FOR THE
THIRD APPELLATE DISTRICT

ALCAN ALUMINUM CORPORATION,
Plaintiff and Appellant,

vs.

FRANCHISE TAX BOARD,
Defendant and Respondent.

By the Court:

Counsel not having requested oral argument within the time provided, the court approves said waiver, and the cause is ordered submitted.

Dated: June 17, 1993

PUGLIA, *P.J.*

cc: See Mailing List

ORDER OF THE SUPREME COURT OF THE STATE OF CALIFORNIA DENYING PETITION FOR REVIEW

(Filed September 22, 1993)

Third Appellate District No. C011530
S033854

IN THE SUPREME COURT OF THE STATE OF CALIFORNIA

IN BANK

ALCAN ALUMINUM CORPORATION,
Appellant,

v.

FRANCHISE TAX BOARD,
Respondent.

Appellant's petition for review DENIED.

The request for an order granting publication of the opinion in the above entitled cause is DENIED.

LUCAS, *Chief Justice*

STATEMENT OF DECISION OF THE SUPERIOR COURT OF CALIFORNIA FOR THE COUNTY OF SACRAMENTO

(Filed May 31, 1991)

No. 322638

DEPT. 9

SUPERIOR COURT OF CALIFORNIA
COUNTY OF SACRAMENTO

ALCAN ALUMINUM CORPORATION,
Plaintiff,

v.

FRANCHISE TAX BOARD,
Defendant.

DECISION ON SUBMITTED MATTER

The above-captioned case came on for oral argument on Friday, March 10, 1991 in Department 9, the Honorable A. Richard Backus residing. Lawrence A. Salibra, II, Esq., appeared for plaintiff Alcan Aluminum Corporation. Philip C. Griffin and Benjamin F. Miller, Deputy Attorney Generals, appeared for defendant Franchise Tax Board of the State of California.

The parties had previously stipulated to the admission of exhibits and filed a Stipulation of Facts. Based on these documents, the parties' briefs, and the oral arguments, the Court hereby issues its decision.

1. *Motion in Limine*

Defendant moved to exclude evidence of cost of compliance on the grounds that plaintiff failed to specify cost of compliance as a ground in its refund claims or failed to provide evidence of cost of compliance at the time its refund claims were considered.

This Court finds that the cost of compliance issue was adequately raised in the refund claims by the references therein to undue burdens. However, the Court finds that plaintiff failed to exhaust its administrative remedies by failing to present to defendant during the administrative process any factual evidence as to what its costs of compliance were or would be.

Accordingly, it is HEREBY ORDERED that defendant's Motion in Limine Re Cost of Compliance is GRANTED. This ruling is actually of no consequence to the outcome of this action because, as stated below, the Court was not required to reach the issue of the burden of the disputed tax method on foreign commerce.

2. *Constitutionality of WWCR*

By this action, plaintiff challenges California's use of the Worldwide Combined Reporting (WWCR) method of accounting as applied to it, i.e., a domestic corporation with a foreign parent, as unconstitutional under the Foreign Commerce Clause of the United States Constitution. (U.S. Const., art. I, §8, cl. 3.) Plaintiff contends that use of WWCR violates the Foreign Commerce Clause under the Dormant Commerce Clause analysis set forth in *Japan Line, Ltd. v. County of Los Angeles* (1978) 441 U.S. 434 and applied in *Container Corp. v. Franchise Tax Bd.* (1982) 462 U.S. 159.

However, this case is controlled by *Wardair Canada Inc. v. Florida Department of Revenue* (1985) 477 U.S. 1, 7-8. In *Wardair*, the Court clarified that the Dormant Commerce Clause analysis set forth in *Japan Line, supra*, for determining whether a tax violates the Foreign Commerce Clause does not apply when the Federal Government has affirmatively acted in a manner which permits the state tax. In *Wardair*, a Canadian airline challenged a state tax on fuel purchased in that state on the ground that it violated the Foreign Commerce Clause. The Court concluded that the Federal Government had affirmatively acted based on "negative implications" from an international convention that precluded local taxes on fuel in some circumstances and from 70 bilateral agreements in which the United States agreed to refrain from imposing national taxes on aviation fuel but did not limit the states' power to tax fuel. (*Id.*, at pp. 10-11.)

In this case too, negative implications from actions by the Federal Government establish that the Federal Government has affirmatively acted to permit the states' use of WWCR. Of particular note is an income tax treaty that the United States Executive Branch negotiated with the United Kingdom in 1975, which included a provision prohibiting states from using WWCR. The senate ratified the treaty only after the provision was omitted. Since then the United States has entered into income tax treaties, which prohibit the Federal Government from using WWCR and include state taxes in non-discrimination clauses, but which do not prohibit states from using WWCR. In addition, since the ratification of the United Kingdom treaty, numerous bills have been introduced in Congress prohibiting states from using WWCR, which have not been enacted.

The above actions establish that by 1978, when the senate ratified the United Kingdom treaty, the senate was certainly aware that the states' use of WWCR was a potential foreign policy problem. Yet it affirmatively continued to allow the use of WWCR by not prohibiting it in subsequent treaties that even mentioned local taxes and by not enacting introduced legislation. These acts are comparable to the acts on which the Court in *Wardair* relied in reaching its conclusion that the Federal Government had affirmatively decided to permit the States to impose the tax at issue. The evidence in this case indicates that the Federal Government has affirmatively acted to allow the states to use WWCR at least until Congress passes legislation to the contrary.

Having concluded that California's use of WWCR does not violate the Foreign Commerce Clause under the principles set forth in *Wardair,* the Court need not reach the question of whether the tax is constitutional under the Dormant Commerce clause analysis set forth in *Japan Line, Ltd. v. County of Los Angeles, supra,* 441 U.S. 434.

The Court thus hereby finds that California's use of the WWCR method of accounting is not unconstitutional under the Foreign Commerce Clause, and judgment shall accordingly be entered against plaintiff and in favor of defendant. Counsel for defendant will prepare, submit to the Court, and serve on counsel for plaintiff a proposed judgment.

DATED: 5-31-91

/s/ A. RICHARD BACKUS
Judge of the Superior Court

EXCERPTS FROM STIPULATION OF FACTS

Exhibit XXI

[Filed in the Superior Court of the State of California, County of Sacramento, No. 322638]

* * *

REASON FOR SHUTDOWN

The Riverside sheet products operation has lost money in every year since 1972, averaging some $900,000 of loss before interest and tax per year during the last four years. (See Appendix 1)

The current Annual Plan predicts a loss of $1.3 million in 1976 and a further loss of $0.7 million next year (after interest but before tax). Sales and booking volumes are running about 10% under plan levels so a substantial additional loss, perhaps up to $0.2 million, can be anticipated. For purposes of this analysis, a continuing pre-tax loss at $1.0-1.5 million per annum is assumed.

Once the plant is shut down and the property and equipment sold, this loss could be eliminated except for Riverside's $150,000 allocated share of the Cleveland office's costs (assuming, conservatively, that the efforts of that office could not be profitably redeployed elsewhere). The estimated annual saving of shutting down Riverside would, therefore, be $850,000 to $1,350,000. Net of depreciation at $360,000 this means an annual cash saving (before tax) of $0.5-1 million.

As of 31 January 1976 the total Riverside operation has $4 million in working capital and another $4 million of net fixed assets for a total capital employed of $8

million (See Appendix 2). Based on an estimated writeoff of $3 million, $5 million can be released for use elsewhere, once the land and buildings are finally sold. Assuming that this $5 million of capital could be employed to earn 10-20% before tax, or $0.5-1 million per year, the Riverside operation would have to generate at least this much cash to justify continuing operations.

Comparing this required profit to the estimated cash loss the gap is then $1-2 million per annum, and this is the principal reason for the proposed shutdown.

ALTERNATIVES

Major Modernization of Riverside Facilities

With a few exceptions, the Riverside equipment is narrow and obsolete. Due to the growth pattern of the facility, the layout is inefficient and the "wide" casting and hot rolling line is too narrow even for double width siding. Any modernization program to increase width capabilities beyond 26" would have to embrace almost the entire plant and would probably cost as much as or more than starting on a green fields basis. The California market would not justify this sort of expenditure.

Move to a New Site

If a sheet mill were to be built from scratch, it is unlikely that California would be the best site due to excessive taxation, stiff pollution controls, and the lack of an adequate market in the area. In any case, the required expenditure would be massive and cannot be contemplated in the forseeable future.

Cold Roll and Coat Only

Various intermediate measures have been reviewed, including shutting down the casting operation only. Unfortunately, none of these make a significant difference partly because the loss of ability to recycle process scrap more or less offsets any overhead savings.

* * *

A28

JOINT REPORT BY INLAND REVENUE AND U.S. TREASURY

UNITARY TAX

REVIEW OF PROGRESS TOWARDS RESOLVING THE PROBLEMS

JOINT REPORT BY INLAND REVENUE AND US TREASURY

December 1991

UNITARY TAX

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JOINT REPORT BY INLAND REVENUE AND US TREASURY

UNITARY TAX

REVIEW OF PROGRESS TOWARDS RESOLVING THE PROBLEMS

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CHAPTER 1: INTRODUCTION

1.1 On 22 March 1989 the Financial Secretary to the Treasury in the UK said that the UK Government believed that progress had been made in the two previous years in resolving the unitary tax issue but that problems remained, in particular the fee which companies had to pay (in California) in order not to be subject to worldwide unitary tax. The Government proposed to review the situation jointly with the US Treasury later in the year (1).

1.2. The aim of this review is to assess progress made in modifying the worldwide combined reporting method of unitary taxation and the need for and possibility of further changes which might be made towards meeting the concerns which have been widely expressed about the present Californian State tax laws as they apply to multinational corporations.

1.3. As part of the review a small party of senior United Kingdom Government representatives went to California (which is the only remaining US State with substantial problems for multinational corporations in this area) in April 1990. The prime purpose of the visit was not to lobby but to seek guidance on the situation in California and the possibilities for further changes in the relevant tax provision.

1.4. The UK Parliament has on a number of occasions expressed its hostility to unitary tax. A motion against the tax was signed by 276 Members (nearly half the Members) of the House of Commons (2) in conjunction with a debate on unitary tax which took place in December 1989. In reply, the Financial Secretary made it clear that it was not the intention of the Government to repeal Section 812 of the Income and Corporation Taxes

Act 1988 which provides a retaliatory power which can be triggered to deny the tax credit which would otherwise be payable to US companies in unitary states (3).

1.5. The US authorities have also on a number of occasions expressed opposition to the States' (particularly California's) use of the worldwide combined reporting method of unitary taxation. President Reagan wrote in November 1985 that the Federal Government supported legislation which would effect a requirement that multinationals be taxed by states only on income derived from the territory of the United States ("the water's edge requirement") (4). Consistent with that statement, the US Department of Justice filed *amicus curiae* briefs in the case of *Barclays Bank International Ltd v. Franchise Tax Board* detailing the US executive branch policy with respect to California's use of worldwide combined reporting, both in the lower court in September 1986 (5) and in the intermediate appellate court in September 1988 (6). Both briefs presented the argument that California's use of worldwide combined reporting was an unconstitutional interference with the US Federal Government's exclusive authority to conduct foreign affairs and regulate foreign commerce. The US Department of Treasury in August 1989 said that the issue of unitary taxation remained a serious concern to the Treasury Department and to the administration of President Bush (7). On 17 November 1990 the Department of Justice appeared before the Californian Court of Appeal to argue the position of the US administration.

CHAPTER 2: WORLDWIDE UNITARY TAX

2.1. The UK and US Governments, together with a number of Governments of other countries, have opposed the use, by the State of California, of worldwide unitary

tax as a means of assessing the Californian tax liability of multinational companies. This method of tax assessment in the circumstances in which it is applied is contrary to the principles underlying the UK/US tax treaty (and other US tax treaties); is contrary to accepted international practice; is extremely cumbersome and burdensome for multinational companies; can result in double taxation of income earned by multinationals outside the US; and effectively extends the reach of the Californian tax authorities beyond the borders of the US.

Methods of taxing multinational corporations

2.2. All tax jurisdictions in which multinationals operate are faced with the problem of determining the amount of income properly attributable to their jurisdiction. The internationally accepted method, which underlies UK and US tax treaties, is known as the separate accounting or arm's length method. This method applies the principle that each taxing authority should levy tax only on the income arising within the borders of its jurisdiction. To enable jurisdictions to assess corporation tax liability, multinational corporations operating within those jurisdictions are asked to provide separate accounts as if they were independent corporations operating at arm's length from other parts of their business.

2.3. The UK and the US, like other taxing jurisdictions, recognize that multinational companies can, in effect, transfer profits between different taxing jurisdictions, by manipulating the prices at which different constituent parts of their multinational business sell goods or services to each other. Like other taxing authorities, the UK and US deal with this by reserving the right, when assessing the extent of a corporation's earnings

attributable to their jurisdiction, to adjust for tax purposes any transfer prices that have been manipulated, so that they reflect the true market price that would be paid between two independent corporations. The UK/US tax treaties, and other tax treaties, specifically allow the contracting states to make such adjustments.

2.4. Unitary taxation is an alternative way of dealing with the same problem. Instead of taxing the income earned within its taxing jurisdiction, a tax authority using unitary tax assesses the overall income of the group, and then levies tax on a certain proportion of that income. That proportion might be calculated by reference to the company's sales, employment, or assets within one taxing jurisdiction.

2.5. The unitary method is used fairly widely by different states in the US in respect of income earned *within the US.* The method works reasonably well where each of the taxing authorities have broadly similar accounting rules and standards and where the tax regimes and formulae used are compatible. These conditions are moderately well satisfied in varying degrees in the different states within the US.

The effects of the worldwide combined reporting method of unitary taxation

2.6. California has chosen to use the same method in respect of worldwide income. In this context the necessary conditions for the successful use of the unitary method are clearly not fulfilled. Accounting standards in different taxing authorities throughout the world vary very considerably from those within the US. Equally importantly, no country (and certainly not the US

Federal Government) adopts such a method. In these circumstances, the use of worldwide unitary tax has the following defects:

a. a multinational company which has to provide accounts to each taxing authority in whose jurisdictions it operates, according to the accounting standards and tax regime of that authority, then has to recalculate its worldwide earnings according to the accounting standards and tax regime of California. Clearly this is a major and costly burden;

b. in practice, determining what constitutes a unitary multinational group in some cases involves highly questionable and arbitrary assumptions. A multinational company which comes to a different judgment from that of the Californian tax authorities could find itself forced to make the burdensome calculations described at a. above several times over;

c. there is no reason in principle why the proportion of a multinational corporation's earnings which are properly attributable to any one taxing authority should necessarily be the same as the proportion of its sales, employment or assets in that taxing authority. If California uses worldwide unitary and other countries use separate accounting/arm's length, a multinational corporation could well end up being taxed on more than 100% of its worldwide income; it could also be taxed on much less than 100% of its worldwide income. The risk of double taxation or double exemption is clearly very real;

d. a multinational company which had assets, sales and payroll in California, but which happened to make a loss in any one year, could find itself paying tax on non-existent (or even negative) income. Or, alternatively, a multinational corporation which improved its profitability in, say, Australia, by reducing costs in that country, would, under the unitary method, find itself paying more tax in California (which would levy tax on a proportion of any increase in profits) even although there had been no change in the income earned in California;

e. the narrow circumstances which may justify an internationally agreed formulary apportionment of income (for example, for 24-hour, global trading of a single book of securities) do not exist in the majority of cases to which California applies the worldwide combined reporting method of unitary tax.

Review conclusion

2.7. We believe that the worldwide combined reporting method of unitary taxation in the circumstances in which it is applied by California remains contrary to internationally agreed standards embodied in the arm's length principle and that the ultimate goal of the UK and US Governments should remain the elimination of the worldwide combined reporting method of unitary taxation.

CHAPTER 3: MODIFICATIONS IN UNITARY TAX LAW

3.1. Since July 1984 there has been action to reform unitary tax in a number of US States—Oregon, Florida, Massachusetts, Montana, Indiana, Utah, Colorado, New Hampshire, Idaho, North Dakota, California and most recently Alaska—although in some cases the application of unitary tax to foreign-owned corporations is limited and not completely eliminated.

3.2. In 1985 the British Parliament enacted legislation (8) giving the UK Government powers to deny tax credits to multinational corporations based in California, as a form of retaliation against the worldwide combined method of unitary taxation. In the following year the Californian Assembly amended Californian law, so as to enable a multinational corporation to "elect" to be taxed on a "water's edge" basis. The "water's edge" basis was broadly similar to the internationally accepted arm's length/separate accounting method. However, this election required payment of an election fee and the Californian tax authorities had the right to disallow such an election (without refunding the fee) in a number of instances, at their sole discretion. This modification in the Californian law that took place in 1986 persuaded the British Government not to bring into operation the retaliatory powers.

3.3. In 1988 some further modifications were made in California which reduced the election period and rendered the Californian tax authorities' decisions subject to some form of appeal. However, the fee remained in the law. In addition, many of the administrative requirements and potential penalties create conditions under which many multinational corporations say that they are unable to operate. The modifications made, although welcome, do

not, therefore, remove all the concerns about the worldwide combined reporting method of unitary taxation.

3.4. This view is shared by other major industrialised countries. In June 1989, all Member States of the European Community reaffirmed in a letter to the US Secretary of State that the present law in California was unsatisfactory. In reply, Treasury Deputy Secretary Robson confirmed that the US shared the European Community's concerns, and stated that further progress would have to be made in California before the US Government's concerns were met (7). In 1989, Canada, Japan, Australia and Switzerland also made clear their continued opposition to the worldwide combined reporting method of unitary taxation.

Review conclusion

3.5. While California (and some other states) have made some significant modifications in their law in response to international criticism, further progress is required before concerns on this issue can be put to rest. To alleviate the concerns of the interested governments, it would be necessary at least to ensure that the choice between the worldwide combined reporting method and the "water's edge" method of reporting should be unconditional and not subject to any fee, penalty, or subsequent override. In pursuing these goals the Governments of the US and the UK recognize that, under the US federal system, provided the method does not infringe upon a power reserved to the Federal Government or is not otherwise denied a State by the US Constitution, the Federal Government cannot dictate precisely how a State determines income subject to its tax jurisdiction.

CHAPTER 4: THE POSSIBILITY OF FURTHER MODIFICATIONS IN CALIFORNIA'S UNITARY TAX LAW

4.1. Senior UK Government representatives went to Sacramento on 23-27 April 1990 following letters from the UK Chancellor of the Exchequer to US Treasury Secretary Brady and Governor Deukmejian and from Secretary Brady to Governor Deukmejian.

4.2. The purpose of the visit was to enable the UK to contribute to this UK/US review of progress on the unitary tax problem, in particular to assess what further modifications in unitary tax law could realistically be expected from the Californian legislature.

4.3. The delegation was grateful to Governor Deukmejian for setting aside time for a substantial meeting with him. The delegation was also grateful to key Senators and Assemblymen from both the Republican and Democratic parties, Senate/Assembly staffers, Californian tax officials and representatives of both Californian and British business who also made time to see them.

4.4. The administration made it clear that it had done much to meet UK concerns in introducing the modifications it had in 1986 and 1988. The Californian legislature had not been prepared to eliminate the worldwide combined reporting method of taxation completely but had provided for an alternative. Some 700 businesses (out of possibly 5000) had elected for water's edge, of which about 50 were UK companies.

Options for reform in 1990

4.5. There seemed to be two possibilities for legislative changes in 1990.

4.6. *First*, a revenue neutral Bill which failed earlier in the year (proposed by Assemblyman *Brown*) was re-introduced, this time by Assemblyman *Peace* (9). This would have reduced the election period (not to be subject to the worldwide combined reporting method of unitary taxation) from 5 years to 3 years and abolished, with treble damages for wilful default, the provision under which companies can be thrown back on unitary tax (the 'throwback') and the domestic spreadsheet. It did not deal with the election fee (see paragraph 4.7 below).

4.7. The *second* possibility for legislation in 1990 was that abolition of the election fee might feature in a Tax Conformity Bill. It was, however, urged on the UK Government delegation by Senators and Assemblymen that the Californian budget currently faced a $2 billion deficit (although the election fee—some $40 million—was small in this context).

4.8. In the event neither legislative possibility materialised and there was virtually no progress on the legislation front in 1990. The only Bill that did pass (*Alquist*) provided mainly for election fees to be refunded with interest if the Courts finally ruled the worldwide combined reporting method of unitary taxation unconstitutional (10).

Meeting with tax officials

4.9. One point that came out of a very detailed meeting the UK delegation had with Californian tax officials was that the latter confirmed that the throwback provision (see paragraph 4.6 above) would be used only in the most extreme circumstances of wilful default. Although it would of course be preferable to have the throwback abolished altogether, this confirmation was helpful and letters were exchanged to this effect.

The future

4.10. The end of the 1988-1990 two year session of the Californian legislature has now passed and there can be no assurance of any immediate modifications to unitary tax law.

4.11. It is understood that the Auditor General is required to make a review of the spreadsheet and make a preliminary report to the Legislature by 31 December 1991.

4.12. The Californian Franchise Tax Board said that when a Bill was introduced in 1989 to repeal the election fee an analysis indicated that this would cost annually something like $100 million. This loss was made up of two components. First, there was the loss of the fee itself which would have had a $35 million impact. Second, under the Board's assumptions, more people would elect if the fee were eliminated giving rise to a $60-$65 million revenue loss. These estimates were mid-year 1989 and economic circumstances had changed which would, in all likelihood, result in a change in the estimates.

Review conclusion

4.13. It is disappointing that no substantial progress was made on legislation in 1990 and that there can be no assurance of any immediate prospect of legislation. However, the undertaking of the Franchise Tax Board on throwback was helpful.

CHAPTER 5: LITIGATION

5.1. Under the US Constitution the power to conduct foreign affairs and to regulate commerce with foreign nations is reserved to the Federal Government. Where

state or local taxes result in actual international multiple taxation, where such a tax "may impair federal uniformity in an area where federal uniformity is essential", and where such a tax prevents "the Federal Government from 'speaking with one voice' when regulating commercial relations with foreign governments", the tax can be held to be unconstitutional by US courts and may not be collected. See *Japan Line Ltd v County of Los Angeles,* 441 US 434 (1979).

5.2. Early efforts to challenge the constitutionality of the Californian worldwide combined reporting method of unitary taxation under this principle were brought by US-based parent corporations with foreign subsidiaries. They did not succeed. See *Container Corporation of America v Franchise Tax Board,* 463 US 159 (1983). The US Supreme Court, however, in a footnote to its decision in *Container,* explicitly stated that it was not addressing the constitutionality of the worldwide combined reporting method with respect to state taxation of US corporations with foreign parents or of foreign corporations. More recently *Colgate-Palmolive Company Inc,* a US-based parent corporation with foreign subsidiaries, has again challenged the constitutionality of Californian worldwide reporting in the Californian Courts. A decision favourable to Colgate in the Californian Superior Court for the County of Sacramento was reversed in August 1991 by the Californian Court of Appeal which could not find a meaningful distinction between that case and the earlier *Container* decision. The company has since filed a Petition for Hearing in the Californian Supreme Court.

5.3. Cases have been brought by foreign corporations and the US subsidiaries of foreign corporations to address the question left open in the *Container* case. In

Barclays Bank International Ltd v Franchise Tax Board, 275 Cal.Rptr.626 (1990), the Court of Appeal of the State of California on 27 December 1990 affirmed the judgment of the Superior Court of California for the County of Sacramento that the worldwide combined reporting method was unconstitutional under the US Constitution's commerce clause. An appeal against that decision has been made by the Franchise Tax Board to the Californian Supreme Court, which has announced that it will hear the appeal. Either party may appeal against its decision to the United States Supreme Court.

5.4. Unlike in the *Container* case, the US Department of Justice filed an *amicus curiae* brief in *Barclays* both before the trial court as well as in the Californian Court of Appeal. The *amicus* briefs presented the argument that California's use of the worldwide combined reporting method is an unconstitutional interference with the US Federal Government's exclusive authority to conduct foreign affairs and regulate foreign commerce. The Californian Appellate Court in its decision in *Barclays* noted that the filing of the *amicus* brief, the US/UK income tax treaty debate, a letter from President Carter's administration to the State of California, and President Reagan's directive to the Attorney General all demonstrated that the US Federal Government had spoken clearly in opposition to the worldwide combined reporting method. The Appellate Court also found that "every single nation in the industrialised western world has sent letters to the United States Government protesting the use of worldwide combined reporting by American states", and took note of the UK's enactment of retaliatory legislation and the cancellation of several trade missions to the United States. The Court also took note of evidence presented to it by Barclays regarding its incurring a one-time cost of between $6.4 million and

$7.7 milion to establish a system of reporting to comply with the requirements of California's worldwide combined reporting and an additional expense from $2 to $3.8 million each year to maintain the system. The Appeals Court decision in *Barclays* was unanimous.

5.5. The Californian Supreme Court has agreed to hear the appeal against the judgment of the Californian Court of Appeal, and the US Government has prepared an *amicus* brief and sought the Court's permission to file it.

5.6. A preliminary injunction was issued in October 1989, in two suits against the Californian Franchise Tax Board, ordering that about $9.5 million in election fees paid to California (fees paid to elect for the use of the water's edge reporting method) be placed into escrow pending the outcome of constitutionality challenges. See *Nestle Holding Inc v FTB,* California Superior Court, San Francisco County, No.911305 and *Coca Cola Company v. FTB,* California Superior Court, San Francisco County, No.911416.

5.7. In recent Court decisions involving *Alcan Aluminium Corp.* it was held that California's use of the worldwide combined reporting method of unitary taxation was constitutional. However, these cases will be proceeding to appeal.

Review Conclusion

5.8. The recent decision (on 27 December 1990) of the Californian Court of Appeal in the *Barclays* case confirms that a satisfactory solution to the problems faced by UK-based multinationals doing business through subsidiaries in California stands a good chance of being reached by litigation in the US courts, particularly where the US Federal Government makes its views known through the filing of *amicus* briefs.

CHAPTER 6: RECOMMENDATIONS TO THE UK AND US GOVERNMENTS

6.1. Following the recent welcome confirmation in the Californian Appeal Court that the worldwide combined reporting method of unitary taxation, as applied to foreign-based unitary groups, is unconstitutional, *we recommend* that both Governments should continue strongly to support litigation against worldwide unitary tax.

6.2. UK Government statements up to 22 March 1989 (1) have made clear that, in the event of the retaliatory legislation being activated, it would not apply to dividends paid on or before 31 December 1989.

6.3. Pending a settlement of the matter by litigation, *the UK reviewers recommend* that the *United Kingdom* should maintain its retaliatory legislation on the statute book, giving no further guarantees as to whether the legislation, if it were to be triggered, would be retrospective, but should not trigger it; *the US reviewers recommend* that the *United States* should defer taking any action on the declaration of President Reagan in 1985 and subsequent statements by the federal authorities, except as recommended in 6.1., above but that the situation shall be reassessed should the position of the US administration not be upheld in Court.

CHAPTER 7: SUMMARY OF CONCLUSIONS

7.1. The reviewers conclude that

a. the worldwide combined reporting method of unitary taxation remains contrary to internationally agreed standards embodied in the arm's length principle (paragraph 2.7);

b. the ultimate goal of the UK and US Governments should remain the elimination of the worldwide combined reporting method of unitary taxation (paragraph 2.7);

c. while California has made some relaxations in its law in response to international criticism, further progress is required before concerns on this issue can be put to rest. Californian tax law should at least ensure a meaningful choice—unconditional and not subject to any fee, penalty or subsequent override—between the worldwide combined method of reporting and the water's edge method (paragraph 3.5);

d. it is disappointing that no substantial progress was made on legislation in 1990 and there can be no assurance of any immediate prospect of legislation (paragraph 4.13);

e. the recent decision in the Californian Appeal Court (on 27 December 1990 in the Barclays case) that the worldwide combined reporting method of unitary taxation, as applied to foreign-based unitary groups, is unconstitutional confirms that a satisfactory solution stands a good chance of being reached by litigation in the US courts (paragraph 5.8); and

f. both Governments should continue strongly to support litigation against worldwide unitary tax (paragraph 6.1);

7.2. Pending a settlement of the matter by litigation,

a. *the UK reviewers* conclude that *the UK* should maintain its retaliatory legislation on the statute book, giving no further guarantees as to

whether the legislation, if it were to be triggered, would be retrospective, but should not trigger it (paragraph 6.3);

b. *The US reviewers* conclude that *the US* should not take any further action on the declaration of President Reagan in 1985 and subsequent statements by the federal authorities, except as stated in paragraph 7.1.f. above but that the situation shall be reassessed should the position of the US administration not be upheld in Court (paragraph 6.3).

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APPENDIX: NOTES

1. HM Treasury Press Release of 22 March 1989.
2. UK Parliamentary motion of 15 December 1989.
3. Hansard 18 December 1989 Cols 172-178.
4. HM Treasury Press Release of 8 November 1985.
5. Superior Court of the State of California, County of Sacramento, Nos 325059 and 325061.
6. Court of Appeal of the State of California, Third Appellate District 3 Civil C003388 (Consolidated with C003389).
7. US Treasury statement of September 1989.
8. Section 812 Income and Corporation Taxes Act 1988.
9. California Legislature—1989-90 Regular Session—Assembly Bill No. 3333.
10. Senate Bill No 2177.